



CLINT ZWEIFEL
MISSOURI STATE TREASURER

August 15, 2012

FROM: Bruce A. Ring, Jr.
Director of Investments

RE: 2011 Annual Program Review

Section 166.450 of the Revised Statutes of Missouri (RSMo) requires an annual review of the Missouri Higher Education Savings Program ("MOST") by the Director of Investments of Treasurer Zweifel's Office and the reporting of the findings to the Missouri Higher Education Savings Program Board ("Board"). The statute requires a review of five areas:

- Board administration
- Financial status
- Investment policy
- Participation rate
- Continued viability

Therefore, in accordance with these requirements, I am pleased to present the following findings from my review for calendar year 2011.

I. Board Administration

Upromise Investments Inc., a division of Upromise, Inc., ("Upromise") assumed responsibility as program manager for both the Direct and Advisor Plans on June 3, 2006. On February 7, 2011, the Board entered into another contract with Upromise, following a Request for Proposal ("RFP") process. The new contract extends to June of 2016. The Board and Treasurer Zweifel's Office continues to work closely with Upromise and monitor its management of the programs. In addition, the Board met quarterly during 2011, as required by law.

II. Financial Status

Following is a review of the financial status of our major partners and a summary of the investment performance of the most popular investment options within the MOST Plan.

A. Financial Status of MOST Partners

Financial markets recovered significantly in 2009 and continued their recovery in 2010. Unfortunately, the recovery stalled somewhat during 2011 and volatility took over as the new concern in the financial markets. There is great unease in the markets with regard to the general economic recovery as well as the debt crisis in Europe. The financial performance of fee-based financial institutions is heavily influenced by assets under management and therefore, valuation of assets is a primary factor. While the recovery of global financial markets in 2009 and 2010 led to an earnings recovery for most financial institutions, 2011 brought a host of different problems for financial managers. Even though 2011 was quite volatile, corporate earnings industry-wide, were fairly strong.

As a result of reductions to the federal government's subsidies to student lenders and dislocations in the student loan industry, Moody's downgraded SLM Corporation, the parent company of Upromise, in early 2009 from "Baa2" to "Ba1". Standard & Poor's and Fitch continue to maintain ratings for SLM of BBB- and all three rating agencies show credit watch stable. SLM's credit rating is not an issue for the MOST plan investment performance or safety of assets because none of the investments of the MOST plan are secured by SLM; however, further downgrades to SLM Corporation's rating would be an indicator that there continues to be concerns regarding the company's profitability.

The investment manager for the Direct Plan in 2011, The Vanguard Group, remained a strong franchise. Vanguard is the top U.S. mutual fund manager as measured by assets under management.

B. Performance of MOST Underlying Funds

Overall, 2011 can be described as a period of high volatility. Absolute returns for equity indices were mixed for the year making 2011 a much more difficult year than 2010. In addition, the Most Advisor plan changed somewhat due to a new contract being put in place and the addition and deletion of some funds.

The return for investment options in MOST, both Direct and Advisor, was, in general, positive, but highly dependent upon the market sector and focus of the fund in 2011. The one-year returns of the funds in the Direct Plan ranged from -14.56% to +13.39%. The returns for all options in the Advisor Plan were similar with a range of -12.35% for the lowest one year return and +13.18% for the best performer. Generally speaking, the magnitude of the return for each individual fund was positively correlated with the amount of equity exposure in each alternative. For the most part, Growth Funds and Small to Mid-Cap Funds performed better than Income or Value Funds during 2011. Active managers were challenged to outperform given the market volatility and macro global and Europe concerns in the market.

Treasurer Zweifel's Office is also responsible for monitoring the relative performance of each of the underlying investment alternatives versus an established benchmark. This effectively measures the contribution that the investment manager's expertise has on participants' returns. Despite good absolute returns for the calendar year, relative performance for most of the funds can best be described as at or below benchmark for the period. To summarize, the investment managers' overall contribution to participants' returns was negative, albeit modestly. As of year-end, two funds in total were on the Watch List for negative short-term performance results. All

passive (index tracking) funds performed satisfactorily, and experienced low tracking error of returns versus their relevant indices.

As of March 31, 2012, the Direct Plan ranked 20th and 33rd out of 54 for one year and three year performance, respectively, according to savingforcollege.com.

For the second quarter in a row, the Advisor Plan ranked 1st out of 35 plans for one year performance, according to savingforcollege.com.

III. Investment Policy

The Missouri Higher Education Savings Program Board adopted a formal investment policy governing program investments in mid-2007. The policy establishes objectives for structuring the investment options in the Direct and Advisor Plan, formulates policies for selecting appropriate investment managers and the use of specific investment vehicles, and establishes an investment performance process for underlying funds in the Plan. The policy is an important statement by the Board in terms of defining its fiduciary responsibilities and standards for Treasurer Zweifel's office staff and MOST partners. The policy was modified in 2008 to allow the Director of Investments, rather than the Board, to make the decision to place or release a fund to/from "WATCH" status. The Board again modified the investment policy in August 2011 to provide that the formal review period for a fund would be three consecutive quarters (as opposed to two consecutive quarters) when looking at benchmark performance evaluation for the Watch List. "Beta" and "Alpha" measures were also added to the review process for funds when determining Watch List eligibility and quarterly performance, as well as the elimination of the "value of active management" measurement criteria.

IV. Participation Rate

Following is an examination of the participation rate of the MOST program. By examining the participation rate for the program, we can attempt to gauge the relative success the state's program has had in reaching the state's residents and encouraging them to increase college savings—the original goal of the IRS section authorizing these programs. The relative success or failure of states' various 529 programs rests on many different factors including the effectiveness of marketing efforts, demographic and economic conditions, cost structure and the abilities and resources of states' partners to attract and retain assets. However, one facet that has remained a constant is the competition for assets among states' program managers. As the field of firms in the 529 industry has shrunk, this competition for assets remains fierce as evidenced by the decline in fees among plans issuing new RFP's in recent years.

A. Growth of Plan in 2011

The MOST Plans experienced growth in both assets and accounts during the year 2011. The asset growth in 2011 is due to both investment returns and increased contributions, while the positive change in number of accounts is primarily the result of increased awareness and popularity of the program.

Combined Plan assets grew by a rate of 5.4% ending the year at approximately \$1.685 billion. Growth was experienced in both the Advisor (7%) and the Direct Plans (5.2%) although the majority of the absolute dollar growth was again accounted for in the Direct Plan. While the plan experienced an increase of 16% in assets during 2010, last year was a more moderate growth year than we have seen in recent years. For the past three years, plan growth has been almost

47%, due in large part to the recovery in the markets after a very poor 2008, and the average plan increase for the past three years has been 15.67%.

Contributions during the period outpaced withdrawals, also contributing to the positive asset growth. Total combined contributions for both plans equaled \$227.97 million, while withdrawals were \$154.3 million. Contributions increased by \$6.27 million in 2011 versus \$221 million in 2010 and \$210 million in 2009. A general increase in contributions should be expected as the economy continues to recover.

The number of accounts grew by a rate of 3.99%, up almost 1% from a year earlier (3%), resulting in a total of 132,050 combined accounts at year-end. The rate of growth was similar for both Advisor (3.7%) and Direct Plans (4%). Roughly 88% of account holders are Missouri residents, an amount relatively unchanged in 2011.

B. Comparison of MOST Participation to National Trends

Nationally, assets in 529 Plans on average have grown significantly over the past decade, but at a decreasing rate. Similar to Missouri, levels plummeted in 2008 due primarily to the financial market performance, but accounts have continued to grow signaling that popularity and awareness across the country is on the rise. Overall, the growth trends for Missouri's MOST Plan, both in respect to assets and accounts, have consistently mirrored the national rates over the past several years.

The 529 Plan landscape is a maturing marketplace and several trends are emerging. Most noticeably is the rise in competition and its impact on program fees. Many states are re-bidding their plans for the first time and this is accelerating the fee reduction impact. As a result, some program managers are even voluntarily reducing fees in a pro-active effort to improve client retention. Innovative and cost-effective market initiatives, as well as more conservative investment options such as CDs, are also prominent trends in the 529 market. Remaining at the forefront of these market trends will be critical to the success and competitiveness of Missouri's MOST program in coming years.

MOST's program management contract with Upromise was renewed in 2011. Some fairly significant changes to the advisor plan (primarily the addition of DWS funds) have positioned the plan for success in the future

V. Continued Viability

The MOST program remains a viable college savings program. In Upromise's five and one-half years of program management we have experienced strong trends in asset and account growth despite the market turmoil that plagued much of this period. We also saw an upswing in the number of new beneficiaries enrolled in the plan, which shows growth of new customers, and much better participation in the Advisor Plan among Missouri-based brokers.

The performance of the Plan throughout the economic downturn and subsequent recovery has been resilient. The fact that participants weren't required to make non-qualified withdrawals on a large scale during this period is promising. As a result, the majority of participants should have experienced almost full recovery of their college savings account balances. The economic environment remains uncertain, but the view in regard to a sustainable recovery and financial markets stability is one of optimism. With this outlook, we should expect to see growth in all

aspects of the plans continue. Increased competition in the 529 marketplace requires innovation and a commitment to excellence to ensure MOST continues to grow.

Missouri's MOST 529 Plan remains not only viable, but well positioned for growth as one of the premiere plans in the Country.